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REPORT
No. 97-390

SECURITIES—COMMODITIES ACCORD AMENDMENTS OF 1982

REPORT

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

TO ACCOMPANY

S. 2260

MAY 12 (legislative day, MAY 11), 1982.—Ordered to be printed

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SECURITIES—COMMODITIES ACCORD AMENDMENTS OF 1982

MAY 12 (legislative day, MAY 11), 1982.—Ordered to be printed

Mr. D'AMATO, from the Commission on Banking, Housing and Urban Affairs, submitted the following

REPORT

[To accompany S. 2260]

The Committee on Banking, Housing and Urban Affairs, to which was referred the bill S. 2260 (the "Securities—Commodities Accord Amendments of 1982"), to amend the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940, having considered the same, reports favorably thereon with an amendment and recommends that the bill, as amended, do pass.

COMMITTEE DELIBERATIONS

Senator D'Amato introduced S. 2260, for himself and Senator Lugar, on March 23, 1982. A hearing on the bill was held on March 31, 1982 before the Subcommittee on Securities.

John S. R. Shad, Chairman of the Securities and Exchange Commission, and Philip McB. Johnson, Chairman of the Commodity Futures Trading Commission, testified at the hearing on March 31, 1982. The Subcommittee also received letters from a number of interested persons commenting upon S. 2260.

PURPOSE OF THE LEGISLATION

S. 2260, the Securities—Commodities Accord Amendments of 1982, would clarify the authority of the Securities and Exchange Commission ("SEC") with respect to the regulation of securities trading. In combination with certain provisions of S. 2109, the "Futures Trading Act of 1982", which has been considered by the Committee on Agriculture, Nutrition, and Forestry, the provisions of S. 2260 would rec-

oncile ambiguities in the securities and commodities laws with respect to the regulatory jurisdiction of the SEC and the CFTC over certain new financial products. In the Committee's judgment, prompt enactment of these amendments is needed in order to resolve issues which have been in contention for far too long.

BACKGROUND

In recent years, the United States economy has undergone dramatic changes. A significant increase in the rate of inflation has severely eroded the value of fixed income investments, and the general rise in short-term and long-term interest rates has been acompanied by a dramatic increase in the volatility of interest rates. The elimination of fixed foreign currency exchange rates, combined with the growing internationalization of world capital and money markets, has introduced exchange rate fluctuation as a component of the risk associated with, not only international business and trade, but also corporate and municipal finance. These factors have affected broad segments of the American economy by introducing new risks or compounding existing risks associated with trade, finance and investment. As a result, businesses and investors have sought means to protect their operations and investments from some of these risks.

In response, both national securities exchanges and boards of trade have developed new trading instruments designed to facilitate risk management. These instruments generally have taken the form of either options or futures contracts (and, as a more recent innovation, options on futures contracts).

The SEC has regulated the exchange market for securities options for nine years. The options currently traded on national securities exchanges consist of standardized put and call options contracts on corporate equity securities. A call option entitles the holder to purchase from the writer of the options contract a specified quantity of the underlying instrument at a specified price at any time prior to the expiration of the contract. A put option entitles the holder to compel the option writer to purchase the underlying instrument at a pre-determined price within a specified time period.

The first standardized options contracts on an equity security were call options introduced by the Chicago Board Options Exchange, Incorporated in 1973. Since that time standardized put options contracts have been added. Proposals by national securities exchanges to trade options on government securities under SEC regulation first were submitted for SEC consideration in 1977. These proposals subsequently were withdrawn at the request of the SEC in accordance with the terms of a temporary moratorium on the expansion of the options markets. Similar proposals and other options proposals relating to various underlying instruments have been submitted by the national securities exchanges since the termination of the options moratorium in 1980.

While standardized options trading was developing on national securities exchanges, the futures markets expanded from trading futures on strictly agricultural products and natural resources to include futures on financial instruments. In 1972, the Chicago Mercantile Exchange began trading futures contracts on several foreign

currencies; this was followed by the development of futures contracts on mortgaged-backed debt securities issued by the Government National Mortgage Association ("GNMA") and on U.S. Treasury securities. These derivative instruments have been used to hedge not only against the risks of price changes in the specific underlying instruments, but also against risks arising from changes in related interest rates.

In many cases the new options and futures products proved quite successful. Bolstered by their initial successes, both securities exchanges and boards of trade in recent years have increased their new initiatives with respect to options and futures on financial instruments.[1] In some instances the new derivative contracts were intended as a refinement of existing contracts. For example, futures contracts on bank-issued domestic and Euro-dollar certificates of deposit and on commercial paper were designed to enable market participants to hedge risks in discrete segments of the interest rate spectrum. In other instances proposals have been developed to permit hedging of other types of risks, such as risks associated with equity investment. The CFTC has recently approved several proposals to trade futures contracts based on stock indices, and applications to trade other similar futures contracts are pending before the CFTC.

Jurisdiction over options and futures on financial instruments is divided between the SEC and the CFTC. The SEC was created in 1934 and vested by statute with jurisdiction over securities trading, including the regulation of securities, securities markets and securities professionals. This comprehensive authority to regulate securities extends to put and call options on securities. However, the failure of the definitional sections of the securities laws expressly to enumerate some instruments, such as standardized put and call options on exempted securities, has been the source of both confusion and litigation. In particular, one court recently concluded that exchange-traded, standardized put and call options on exempted securities were not themselves securities and that the sole authority of the SEC to regulate put and call options is derived from Section 9 of the Securities Exchange Act. *Board of Trade of the City of Chicago* v. *Securities and Exchange Commission and Chicago Board Options Exchange, Incorporated*, No. 81–1660 (7th Cir. 1982). The Court in a two-to-one decision held that options on GNMA securities are not securities and that, therefore, the SEC lacks authority to approve a proposal by a national securities exchange to trade such instruments. The Court also held that GNMA options are subject to the exclusive jurisdiction of the CFTC and that, subject to the conditions of the commodity options ban, trading in such instruments is unlawful. That decision, if left undisturbed, could be read broadly to jeopardize SEC authority over trading which the Committee believes is plainly within its regulatory domain. In any event, the decision will cause further uncertainty and delay in resolving these issues, unless appropriate amendments to the securities and commodities laws are adopted.

The CFTC was created in 1974 and vested in Section 2(a)(1) of the Commodity Exchange Act ("CEA") with exclusive jurisdiction over

[1] In addition, at least one securities exchange has filed an application with the SEC to trade as a package groups of securities. Since the SEC has the authority to regulate trading in the securities which make up the group, the SEC would have ample authority to regulate trading in the group.

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"accounts, agreements (including any transaction which is of the character of . . . an 'option') * * * and transactions involving contracts of sale of a commodity for future delivery." Pursuant to this authority the CFTC regulates commodity futures and commodity options, as well as futures markets and futures professionals. Also in 1974, the definition of the term "commodity", in the CEA was amended to include, in addition to certain specified agricultural products, "all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in." The CFTC also was granted plenary authority over options "involving any commodity".

This broad language is tempered by other statutory provisions and the legislative history of the CEA which recognized the SEC's regulatory authority with respect to trading of puts and calls on securities. In recent years, proposals by national securities exchanges to expand their equity options programs to include options on instruments that are the subject of futures trading have raised questions concerning whether the SEC or the CFTC is the appropriate agency to regulate trading on such instruments. With respect to options, the SEC consistently has asserted that it, and not the CFTC, has authority to regulate options trading on national securities exchanges. Similar jurisdictional questions have been raised by proposals by boards of trade to introduce futures trading on various securities and securities aggregates. The CFTC has consistently asserted that it, rather than the SEC, has authority to regulate such futures contracts.

The failure of the federal securities laws and the CEA to articulate a clear line of demarcation between the authority of the SEC and that of the CFTC has created several unfortunate consequences. When innovative and potentially useful trading instruments have been proposed, the focus of public debate often has not been on the merits of the proposals or their specific terms, but instead on the issue of which agency is granted jurisdiction. As a result, the two agencies as well as market participants have diverted resources from the evaluation of the merits of the proposals to an examination of the jurisdictional questions. In some instances agency approval of new product proposals has culminated in litigation. Moreover, resort to litigation to resolve jurisdictional issues has substantially delayed the introduction of new trading instruments broadly endorsed by prospective users and other federal regulators as likely to serve a useful economic function.

In order to remove these jurisdictional uncertainties, the SEC and the CFTC determined that it was in the public interest to seek an agreement concerning the appropriate meaning of inconsistent provisions in the relevant statutes. Following a series of meetings, a decision was reached by the two agencies to propose jointly legislative amendments to the statutes administered by both agencies, in order to codify the interpretations agreed upon by the agencies. Pursuant to their agreement, the agencies drafted legislative proposals which were submitted to Congress and incorporated into S. 2260 and S. 2109. The bills together specifically address the jurisdictional status of options and futures that relate to a number of underlying financial instruments. The legislation also clarifies the allocation of authority between the SEC and the CFTC in several other areas. This resolution of the issues will serve the public interest in general, and business,

commerce and investment in particular, by removing impediments to innovation and promoting competition in the development of new financial products, and by permitting the benefits of new instruments to be available without undue delay.

The Committee commends the two agencies for reaching agreement and for their joint action in supporting the amendments under consideration. The developments which have made clarifying legislation desirable also make it clear that continued cooperation between the SEC and the CFTC is needed. The Committee expects that the two agencies will continue to cooperate in resolving any future issues which may arise.

NATURE AND SCOPE OF THE BILL

S. 2260 would amend the securities laws to clarify the jurisdiction of the SEC over options trading. As noted above, this bill is part of a legislative package that includes certain amendments to the CEA, clarifying the jurisdiction of the CFTC over options and futures, that are contained in S. 2109, and that have been considered by the Senate Committee on Agriculture, Nutrition, and Forestry. In light of the relationship between the two bills, the Committee has taken both into account in its deliberations, and the discussion which follows includes references to amendments contained in S. 2109 which bear on the scope of the SEC's authority.

A. Options on securities

The legislation would specify that the SEC has sole authority to regulate options on securities, including exempted securities. This result would be accomplished by provisions in S. 2260 and amendments to the CEA in S. 2109 specifically providing that the CEA does not apply to any put or call option on a security or a securities aggregate and to prohibit the CFTC from designating a board of trade to trade such options.

The definition of the term "security" in the Securities Act, the Securities Exchange Act, the Investment Company Act, and the Investment Advisers Act would be amended to include explicitly among the instruments enumerated any put or call option on a security.[2] Although such options currently are considered to be within the definitions of "security", these amendments would further clarify that such options are themselves separate securities. The definition would also include options on securities groups and indices and on certificates of deposit, as well as any option on a foreign currency if the option is traded on a national securities exchange.[3]

Nothing in the CEA would govern or in any way be applicable to an option on foreign currency trade on a national securities exchange. Neither bill would affect any existing authority of the CFTC to regulate other options trading on foreign currency.

[2] While the amended definition of "securitiy" would make it clear that put and call options are securities, the SEC would retain its authority to treat such securities as "exempted securities." The Committee believes that such treatment is appropriae for certain over-the-counter options, such as the optional delivery contracts employed by the Federal Home Loan Mortgage Corporation in connection with its mortgage purchase and securities sale activities.

[3] The term "foreign currency" itself is not defined. The Committee intends that, for the purposes of S. 2260, the term "foreign currency" not include bullion-valued gold coins bought and sold as investment vehicles, such as the South African Krugerrand and the Canadian Maple Leaf.

The SEC's authority over options trading would be further clarified by amendments to Section 9 of the Securities Exchange Act to establish that the SEC's plenary authority to regulate options trading in that Act extends to options on all securities, on certificates of deposit, on securities groups and indices, and on options on foreign currency traded on a national securities exchange.

B. Futures on securities

The trading of futures on individual corporate or municipal securities raises a number of significant issues, including the possible impact on the market for the underlying security. While it may well be possible to resolve these concerns, the Committee agrees with the SEC and the CFTC that it is not appropriate at this time to permit trading in futures on individual corporate and municipal securities. Accordingly, proposed amendments to the CEA in S. 2109 would make unlawful futures trading on any security, other than an exempted security (as defined by Section 3 of the Securities Act or 3 (a)(12) of the Securities Exchange Act) which is not a municipal security. The boards of trade, under the jurisdiction of the CFTC, could continue to trade futures on GNMA's, Treasury securities, certificates of deposit, and commercial paper, as well as any other futures contracts which would be consistent with this limitation. Under existing law, the CFTC also may authorize trading of options on any permissible futures contract, provided that certain statutory requirements are met. A pilot program, limiting each board of trade to one options contract, has recently been approved by the CFTC.

C. Futures on groups or indices of securities

Under proposed amendments to the CEA contained in S. 2109, the CFTC would be explicitly permitted to designate a board of trade as a contract market for trading futures contracts (or options on such contracts) on securities groups or securities indices. In order to designate such a contract, the CFTC would be required to determine that the proposed contract (or option on such contract) meets certain minimum requirements, in addition to those currently specified in the CEA and the rules and regulations thereunder applicable generally to contract market designations. These requirements are intended to provide a board of trade with the necessary flexibility to design futures contracts that are responsive to the hedging and investment needs of market participants, while at the same time asuring that future trading is limited to broad-based securities groups or indices that are not conducive to manipulation or disruption of the market for the underlying securities. For example, the amendments would expressly require that the CFTC determine that trading in a proposed contract would not be readily susceptible to manipulation of the futures contract or of related securities markets. The Committee notes that, in their Joint Explanatory Statement describing the proposed legislation, the SEC and CFTC discussed the proposed statutory standards for approval futures contracts on groups or indices. Among other things, the two agencies indicated that "it appears unlikely that indices not now in existence, based on bonds issued by a group of affiliated companies or on small industry groups, would meet such standards."

In view of the SEC's strong regulatory interest in the trading of securities which may be components of stock groups or indices, as well as Congressional interest in assuring coordination between the activities of the two agencies, amendments to the CEA contained in S. 2109 would provide the SEC with an explicit role in the CFTC's administrative process of designating contract markets for the trading of futures contracts on stock groups and indices. S. 2109 would create a more extensive role for the SEC than the role now provided for the Department of the Treasury and the Federal Reserve Board in connection with contracts relating to government securities. In addition, in order to facilitate cooperation between the SEC and the CFTC and the entities they regulate in conducting surveillance, S. 2109 would amend the CEA to remove existing statutory impediments to transmission by the CFTC of trade information to securities self-regulatory organizations and to registered futures associations.

Commodity pools

While the CFTC has adopted regulations governing the activities of commodity pool operators and has exclusive jurisdiction with respect to "accounts * * * involving" futures, uncertainty has existed with respect to the extent to which the activities of a commodity pool as a company, e.g., its formation, capital-raising, and periodic disclosure, are subject to the federal securities laws. Proposed amendments to the CEA in S. 2109 would clarify the applicability of the Securities Act and the Securities Exchange Act to securities issued by commodity pools and transactions in such securities. Moreover, in appropriate circumstances, commodity pools and persons managing them may be subject to the Investment Advisers Act and, if a pool also acts as an investment company, to the Investment Company Act.

SECTION-BY-SECTION ANALYSIS OF S. 2260

To accomplish the purposes discussed above, S. 2260 would amend the Securities Act, the Securities Exchange Act, the Investment Company Act, and the Investment Advisers Act.

Section 2

This section of the bill would amend Section 2(1) of the Securities Act of 1933 (15 U.S.C. 77b(1)), which defines the term "security", to include among the instruments specifically enumerated "any put, call, straddle, option, or privilege on any security." This amendment would make clear that such instruments are themselves separate securities. In addition, the amended definition would make clear that options on groups and indices of securities, options on certificates of deposit and, when traded on a national securities exchange, options on foreign currency are securities. The proposed treatment of options on certificates of deposit under the Securities Act is not intended to affect existing law governing the circumstances under which certificates of deposit may be securities.

Section 3

This section of the bill would amend Section 3(a)(10) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(10)), which defines the term "security," to make changes identical to those made in the defini-

tion of the term "security" in the Securities Act. The amendment would make clear that an option on an exempted security is a separate security. Accordingly, a person in the business of effecting transactions in such instruments would, absent an applicable exemption, be required, pursuant to Section 15 of the Securities Exchange Act, to register with the SEC as a broker or dealer. To the extent, however, that such a requirement would impose an unnecessary burden on certain entities, including government securities dealers, involved in effecting transactions in options on government securities, the Committee anticipates that the SEC would exercise its authority to grant administrative exemptions.

Section 4

This section of the bill would amend Section 9 of the Securities Exchange Act (15 U.S.C. 78i) to make it clear that the SEC's plenary authority over options trading on national securities exchanges extends to options on securities, securities groups and indices, certificates of deposit, and, when traded on a national securities exchange, options on foreign currency.

Section 5

This section of the bill amends Section 2(a)(36) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(36)), which defines the term "security," to make explicit that the term includes "any put, call, straddle, option or privilege on any security including a certificate of deposit, or any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option or privilege entered into on a national securities exchange relating to foreign currency." The proposed treatment of options on certificates of deposits in the Investment Company Act would recognize that the underlying certificates of deposit clearly are securities for the purpose of the Investment Company Act.

Section 6

This section of the bill amends Section 202(a)(18) of the Investment Advisers Act of 1940 (15 U.S.C. 80b–2(a)(18)), which defines the term "security," to make changes identical to those made in the definition of "security" in the Investment Company Act.

FISCAL IMPACT STATEMENT

No provision in S. 2260 is intended by the Committee to authorize new budget authority.

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, D.C., May 11, 1982.

Hon. JAKE GARN,
Chairman, Committee on Banking, Housing and Urban Affairs, U.S. Senate, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: Pursuant to Section 403 of the Congressional Budget Act of 1974, the Congressional Budget Office has reviewed S. 2260, Securities—Commodities Accord Amendments of 1982, as ordered reported by the Senate Committee on Banking, Housing and Urban Affairs, May 10, 1982.

S. 2260 would clarify the jurisdiction of the Securities and Exchange Commission (SEC) relating to financial instruments regulated by the SEC and the Commodity Futures Trading Commission. Since the SEC monitoring system is already in place, it is expected that enactment of this legislation would have no budget impact.

Should the Committee so desire, we would be pleased to provide further details on this estimate.

Sincerely,

RAYMOND C. SCHEPPACH,
(For Alice M. Rivlin, Director).

REGULATORY IMPACT

Pursuant to Rule XXVI, paragraph 11(b) of the rules of the Senate, the Committee has evaluated the regulatory impact of the bill and concludes that it would reduce existing regulatory burdens.

The principal purpose of the bill is to remove existing uncertainty about the scope of SEC and CFTC authority with respect to the trading of options and futures contracts on financial instruments. By clarifying ambiguities in existing law, the bill is expected to reduce the delays involved in developing new products and promote competition.

CHANGES IN EXISTING LAW

In the opinion of the Committee, it is necessary to dispense with the requirements of Section 4 of Rule XXIX of the Standing Rules of the Senate in order to expedite the business of the Senate.

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